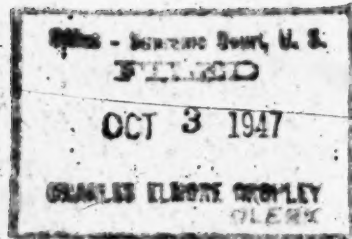


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No. **384**  
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*In the Supreme Court of the United States*

OCTOBER TERM, 1947

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COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

SOUTH TEXAS LUMBER COMPANY

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED  
STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH  
CIRCUIT

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**v.**

**SOUTH TEXAS LUMBER COMPANY**

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## **PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT**

The Solicitor General, on behalf of the Commissioner of Internal Revenue, prays that a writ of certiorari issue to review the judgment of the United States Circuit Court of Appeals for the Fifth Circuit entered July 3, 1947, reversing the decision of the Tax Court of the United States entered August 30, 1946.

### **OPINIONS BELOW**

The opinion of the Tax Court (R. 30-35) is reported in 7 T. C. 669. The opinions in the Circuit Court of Appeals (R. 51-54) are not yet reported.

### **JURISDICTION**

The judgment of the Circuit Court of Appeals was entered on July 3, 1947. (R. 54.) The juris-

diction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

#### QUESTION PRESENTED

The taxpayer reports (for excess profits tax as well as income tax purposes) its gains from sales of real estate upon the installment basis under Section 44 of the Internal Revenue Code, whereby such gains are reported and taxed only to the extent that they are reflected in installments actually received by the taxpayer.

The question presented is whether the taxpayer may, in computing its excess profits credit for 1943, include in its equity invested capital the uncollected and unreported profits from such installment sales, on the theory that they represent "accumulated earnings and profits" under Section 718 (a) (4) of the Code.

#### STATUTES AND REGULATIONS INVOLVED

The pertinent statute and Treasury Regulations are set out in the Appendix, *infra*, pp. 16-26.

#### STATEMENT

The Tax Court found the facts as stipulated (R. 31-34) which, so far as material here, are as follows:

South Texas Lumber Company, hereinafter referred to as the taxpayer, is a corporation organized on September 17, 1902, under the laws of the State of Texas with its principal place of business

as a retail dealer in lumber and building material located in Houston, within the First Collection District of Texas. (R. 31.)

The taxpayer keeps its books and files its income and excess profits tax returns on the calendar year and accrual basis. (R. 31.)

During the course of its business life, the taxpayer acquired title to certain real estate situated in the State of Texas. Beginning with the taxable year 1937, the taxpayer has made sales of portions of such real estate and, in accordance with Section 44 (b) of the Internal Revenue Code, has elected to compute and report the profit thereon on the installment basis. In each of the transactions where the taxpayer made such real estate installment sales, deeds were given to purchasers, and the deferred payments were evidenced by promissory notes executed by the purchaser payable to the order of the taxpayer as therein shown, and were secured by vendor's lien and mortgage lien against the land. The taxpayer, being on the accrual basis of accounting, carried on its books as receivables all of the installment obligations so received by it from such sales. (R. 31.)

At the time provided by law, the taxpayer filed corporation income tax (Form 1120) and corporation excess profits tax (Form 1121) returns for the calendar years 1941, 1942 and 1943, disclosing net income and income taxes due thereon for the three years and excess profits tax for the calendar



year 1943. In arriving at the net income for the three years, the taxpayer reported the following realized profits on the installment sales previously referred to above (R. 33):

	1941	1942	1943
1937 sales-----	\$3,043.49	\$2,136.34	\$2,396.87
1938 sales-----	903.70	1,135.81	403.13
1941 sales-----	21.84	196.56	190.98
Total-----	3,969.03	3,468.71	2,990.98

The balance sheets attached to and made a part of the income tax returns disclosed the following unreported income from installment sales classified as "Unrealized Profit Installment Sales" (R. 33):

	12-31-40	12-31-41	12-31-42	12-31-43
1937-----	\$8,541.39	\$5,497.90	\$3,361.56	\$964.69
1938-----	2,442.64	1,538.94	403.13	0
1941-----	0	1,070.36	873.80	682.82
Total-----	10,984.03	8,107.20	4,638.49	1,647.51

In its corporation excess profits tax return, Form 1121, for the calendar year 1943, the taxpayer claimed the unreported income from installment sales, \$4,638.49, as a part of surplus and undivided profits in arriving at its equity invested capital. It also claimed the unreported income from installment sales, \$10,984.03, as at December 31, 1940, and \$8,107.20 as at December 31, 1941, in arriving at its equity invested capital for the calendar years 1941 and 1942, respectively, for the purpose of its unused excess profits credit carry-over from the calendar years 1941 and 1942 to the calendar year 1943. (R. 33-34.)

The tax in controversy in this case is the excess

profits tax for the calendar year 1943. The Commissioner, as disclosed by the statutory notice of deficiency dated November 5, 1945, reduced the taxpayer's equity invested capital for the calendar years 1941, 1942 and 1943 by the amounts of unreported profits from installment sales previously referred to above in the respective amounts of \$10,984.03, \$8,107.20 and \$4,638.49. (R. 34.)

The Tax Court sustained the Commissioner's determination (R. 35), but the court below reversed the Tax Court's decision (R. 54).

#### **SPECIFICATION OF ERRORS TO BE URGED**

The Circuit Court of Appeals erred:

(1) In holding that the taxpayer, which reported its profits from sales of real estate for income and excess profits tax for the taxable year 1943 on the installment basis of return under Section 44 (b) of the Internal Revenue Code, may for excess profits tax purposes include in its equity invested capital uncollected and unreported profits from such installment sales of real estate outstanding on its books as of January 1, 1941, 1942, and 1943, on the theory that these profits represent "accumulated earnings and profits as of the beginning of such taxable year," under Section 718, (a) (4) of the Code.

(2) In failing to hold that subsection (1) of Section 115, defining "earnings and profits," is applicable to a determination of the taxpayer's "accumulated earnings and profits as of the be-



ginning of such taxable year" under Section 718

(a) (4) for the purpose of computing its equity invested capital for excess profits credit purposes.

(3) In failing to apply Section 29.115-3 and Section 29.115-12 of Treasury Regulations 111, promulgated under the income tax provisions of the Code, and Section 35.718-2 of Treasury Regulations 112, promulgated under the excess profits tax provisions thereof, in the determination of the taxpayer's "accumulated earnings and profits at the beginning of such taxable year", in computing its equity invested capital for excess profits credit purposes under Section 718 (a) (4).

(4) In failing to hold that uncollected and unreported profits of the taxpayer on installment sales are not "recognized" for tax purposes under Sections 44, 111 and 112 of the Internal Revenue Code and may not be included in "accumulated earnings and profits" under Section 718 (a) (4).

(5) In reversing the Tax Court's decision.

#### REASONS FOR GRANTING THE WRIT

1. In determining a corporation's "equity invested capital" for excess profits tax purposes, Section 718 (a) (4) of the Internal Revenue Code provides that there shall be included its "accumulated earnings and profits" as of the beginning of the taxable year.<sup>1</sup> The question in this case is

<sup>1</sup> The excess-profits tax is imposed with respect to profits in excess of a specified credit, and that credit may be based upon stated percentages of the corporation's "invested cap-

whether the taxpayer may include uncollected and unreported profits on installment sales in determining its "earnings and profits" under Section 718 (a) (4), thereby increasing its excess profits credit. The taxpayer keeps its books on the accrual basis, but it has taken advantage of the privilege accorded to it by Section 44 (b) of the Code, to compute and report on the installment basis the profits made on installment sales of real estate. Thus, the profit on a particular sale is allocated to the various installments, and the taxpayer reports proportionate amounts of the profit and pays a tax thereon only as the installments are actually received. In accordance with that method, the taxpayer was not required to and in fact did not report as income any gain on its sales that was attributable to installments which it had not yet received. However, it nevertheless insists, and the court below so held, reversing the Tax Court, that it may include such unreported and uncollected gains in computing its "earnings and profits."

The result thus reached by the court below is not only in conflict with the basic statutory scheme, but it renders invalid a Treasury Regulation which explicitly requires that a corporation's "invested capital" be computed as follows: "Secs. 710, 711, 742, 714. The invested capital is defined to consist of the sum of the corporation's 'equity invested capital' and its 'borrowed invested capital.' Sec. 717. And Section 718 spells out in detail the method of computing 'equity invested capital.'"

tion computing its income on the installment basis must also compute its "earnings and profits" on the same basis. Section 29.115-3 of Regulations 111. The erroneous decision below not only affects the excess profits tax liability of all corporations that reported income on the installment basis, but it also has much wider application with respect to income taxes generally in that it embodies a concept of "earnings and profits" which directly affects the question whether a corporation distributes taxable dividends to its stockholders.<sup>2</sup> It is therefore a matter of great importance to the orderly administration of the tax laws that the decision below be reviewed.

2. The decision below is sharply at variance with the statutory scheme and the applicable Treasury regulations. Section 115 (1) of the Internal Revenue Code, after describing the method of determining gain or loss from the sale of property by a corporation for the purpose of computing its "earnings and profits," explicitly

---

<sup>2</sup> A corporate distribution to stockholders results in a taxable dividend only if it is paid out of "earnings and profits." Section 115 (a) of the Internal Revenue Code. And longstanding administrative practice has treated distributions as not constituting dividends where they were paid out of gains which had not yet been recognized by the corporation for its income tax purposes. If the decision below properly reflects the law applicable to determining the "earnings and profits" available for distribution, it may be necessary for the Commissioner to reopen the tax liabilities of stockholders for past years (to the extent not barred by limitations) and to assert deficiencies based upon this decision.

provides: "Gain or loss so realized shall increase or decrease the earnings and profits to, but not beyond, the extent to which such a realized gain or loss was recognized in computing net income under the law applicable to the year in which such sale or disposition was made." And if there were otherwise any doubt in this regard, Section 29.115-3 of Regulations 111, makes it doubly clear that profits reflected in unpaid installments (which have not been reported as income by reason of Section 44 of the Code) are not to be included in the corporation's earnings and profits. These regulations unambiguously provide that " \* \* \* a corporation computing income on the installment basis as provided in section 44 shall, with respect to the installment transactions, compute earnings and profits on such basis \* \* \*." These provisions are further fortified by Section 29.115-12, which states:

The gain or loss so realized [upon sale of property] increases or decreases the earnings and profits to, but not beyond, the extent to which such gain or loss was *recognized* in computing net income under the law applicable to the year in which such sale or disposition was made. As used in this subsection the term "recognized" has reference to that kind of realized gain or loss which is recognized for income tax purposes by the statute applicable to the year in which the gain or loss was realized, for

example, see section 112.<sup>3</sup> \* \* \* [Italics in original.]

Moreover, the regulations make it plain that these provisions apply to excess profits taxes as well as ordinary income taxes. Section 29.115-12 states that the rules for determining gain or loss under Section 115 (1) of the Code "are applicable whenever under any provision of chapter 1 [containing the ordinary income tax provisions]

<sup>3</sup> The provisions of Section 29.115-12 quoted above show that they are not limited to gains or losses the recognition of which is governed exclusively by Section 112, since it refers to Section 112 with the words "for example." Accordingly, these provisions are also applicable to recognition or non-recognition under the installment sales provisions of Section 44, as is made clear by Section 29.115-3, quoted above, which explicitly refers to Section 44.

But even if it were necessary to bring the case within Section 112, it is persuasive from an examination of the statute that the provisions of Section 44 are to be regarded as read into Section 112. For, Section 112 (a) declares that the entire amount of gain or loss, determined under Section 111 shall be recognized, except as thereafter [i. e., in Section 112] provided. Although none of the exceptions applies to installment sales, it seems plain that the general reference to Section 111 brings into play not merely Section 111 (c) (which refers to Section 112 to determine the extent of recognition of gain or loss upon sale) but also Section 111 (d) (which deals exclusively with installment sales and takes into account the special provisions of law governing such sales). Accordingly, it may fairly be said that the reference in Section 112 (a) to Section 111, which in turn takes installment sales into account, assimilates the installment sales non-recognition provisions of Section 44 with like provisions in Section 112. In short, the gain on an installment sale is "recognized" under Sections 111 and 112 to the extent that it is subjected to tax in a given year under Section 44.



or 2 [containing the excess profits tax provisions] it is necessary to compute either the total earnings and profits of the corporation or \* \* \*.”

And the same section also describes the total earnings and profits of a corporation as being “of most frequent application in determining invested capital”, which is relevant only for excess profits tax purposes. Furthermore, Section 728 of the Code provides that “The terms used in this subchapter [i. e., the subchapter which imposes the excess profits tax] shall have the same meaning as when used in Chapter 1 [the chapter which imposes the ordinary income taxes and which contains such provisions as Section 115].” See Appendix, *infra*, p. 22. And Section 35.718-2 of Treasury Regulations 112, promulgated with respect to the excess profits taxes, refers specifically to Section 115 and accompanying regulations for the meaning of the term “accumulated earnings and profits.”<sup>4</sup> See Appendix, *infra*, p. 25.

<sup>4</sup>If there were any residual doubts as to the applicability of Section 115 (1) and the regulations under Section 115 with respect to excess profits taxes, these doubts would be resolved by the legislative history of the statute which added Section 115 (1) to the Code. Thus the report of the House Ways and Means Committee pointed out that the new provisions were intended to clarify the meaning of the term “earnings and profits,” and that “this is important not only for the purpose of determining whether distributions are taxable dividends *but also in determining equity invested capital for excess-profits-tax purposes.*” [Italics supplied.] H. Rep. 2894, 76th Cong., 3d Sess., p. 41. See also H. Rep. 3002 [conference report], 76th Cong., 3d Sess., p. 60. These new

3. The decision below is in conflict with the principles recognized by this Court in *Commissioner v. Wheeler*, 324 U. S. 542. Although the validity of the retroactive provisions of Section 501 (a) of the Second Revenue Act of 1940 [which added Section 113 (1) to the Internal Revenue Code] was ostensibly involved, this Court found it unnecessary to pass upon the constitutional issue. For, it held that the new provisions were simply declaratory of pre-existing law, as reflected in outstanding valid regulations. The particular regulation upheld was Article 115-3 of Treasury Regulations 101 which provided, *inter alia*, that "Gains and losses within the purview of section 112 or corresponding provisions of prior Acts are brought into the earnings and profits at the time and to the extent such gains and losses are recognized under that section." The Court thus disapproved, at least impliedly, such decisions as *Commissioner v. F. J. Young Corp.*, 103 F. 2d 137 (C. C. A. 3) which were the immediate cause for the legislation before the Court in the *Wheeler*

provisions were undoubtedly submitted in response to the recommendations of a subcommittee of the House Ways and Means Committee, dated August 8, 1940, entitled "Proposed Excess-Profits Taxation and Special Amortization—1940" (76th Cong., 3d Sess.), p. 14. The subcommittee recommended that the term "earnings and profits" as used in Chapter 1 be "clarified" in order that the unrecognized gain or loss on the sale of property by a corporation be not reflected in its earnings and profits account.

case.<sup>5</sup> However, cases such as the *F. J. Young Corp.* case were the basis for the decision in *Commissioner v. Shenandoah Co.*, 138 F. 2d 792 (C. C. A. 5), which the court below regarded as controlling in the present case. But the *Wheeler* case, in recognizing the validity of the regulations involved, destroyed the entire structure upon which this line of cases rested. The dissenting opinion of Judge Holmes in the court below regarded the *Shenandoah Co.* case as having been overruled "in principle" (R. 54) by the *Wheeler* case, thus removing the very foundation upon which the majority placed its decision.<sup>6</sup>

<sup>5</sup> See H. Rep. 2894, 76th Cong., 3d Sess., p. 42, which refers to the *Young* case by name as the type of situation to which the new legislation was addressed. As indicated above, this new legislation added Section 115 (1) to the Internal Revenue Code. The *Young* case had held, contrary to the regulations sustained in the *Wheeler* case, that gains which were realized were to be included in a corporation's earnings and profits, notwithstanding that such gains had not yet been recognized for income tax purposes. The new provisions added in Section 115 (1) were thus intended as a legislative reversal of the *Young* case. However, this Court's decision in the *Wheeler* case is to the effect that the new legislation was simply declaratory of prior law, with the consequence that the *Young* case must be regarded as having been erroneously decided.

<sup>6</sup> The majority also noted (R. 53-54) that the decision in *Kimbrell's Home Furnishings, Inc. v. Commissioner*, 7 T. C. 339, which was in accord with the Tax Court's decision in the present case had been reversed in the Fourth Circuit (159 F. 2d 608). Whatever may be said as to the correctness of that reversal, however, the *Kimbrell's* case differs from the present case in a crucial respect. In the *Kimbrell's* case, the taxpayer

4. The decision below is in conflict with decisions of the Court of Claims and the Circuit Courts of Appeals for the Second and Ninth Circuits under a corresponding provision of prior law. The same issue as is involved in this case arose on numerous occasions under Section 326 (a) (3) of the Revenue Act of 1918 (c. 18, 40 Stat. 1057) with respect to the war-profits and excess-profits tax then in effect. This provision reads as follows:

SEC. 326. (a) That as used in this title the term "invested capital" for any year means (except as provided in subdivisions (b) and (c) of this section):

\* \* \* \* \*

(3) Paid-in or earned surplus and undivided profits; not including surplus and undivided profits earned during the year;

Although the language of this provision is not identical with Section 718 (a) (4) of the Code, here involved, both provisions in effect require the inclusion of accumulated earnings and profits

had taken advantage of an option in Section 736 (a) of the Code, whereby it accrued (for excess profits tax purposes) its gains on installment sales in the year that sales were made, and actually paid taxes with respect to such gains. Such gains were thus in fact *recognized* for excess profits tax purposes and were therefore included in the corporation's "earnings and profits." In the present case, on the other hand, the gains involved have not been accrued in the years of the sales; these gains, reflected in uncollected installments, were *not recognized* and therefore not reported during the years involved.

in invested capital. And under the 1918 Act, it was uniformly held that uncollected gains on installment sales in the case of taxpayers reporting on the installment basis are not to be included in earnings of the taxpayer for the purpose of determining its invested capital. See e. g., *Schmoller & Mueller Piano Co. v. United States*, 67 C. Cls. 428; *John M. Brant Co. v. United States*, 40 F. 2d 126 (C. Cls.), certiorari denied, 282 U. S. 888; *Standard Computing Scale Co. v. United States*, 52 F. 2d 1018 (C. Cls.); *Jacob Bros. Co. v. Commissioner*, 50 F. 2d 394 (C. C. A. 2); *Tull & Gibbs v. United States*, 48 F. 2d 148 (C. C. A. 9).

#### CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

PHILIP B. PERLMAN,  
Solicitor General.

OCTOBER, 1947.



## APPENDIX

### Internal Revenue Code:

#### CHAPTER 1—INCOME TAX

##### SEC. 41. GENERAL RULE.

The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. If the taxpayer's annual accounting period is other than a fiscal year as defined in section 48 or if the taxpayer has no annual accounting period or does not keep books, the net income shall be computed on the basis of the calendar year. (26 U. S. C. 1940 ed., Sec. 41.)

SEC. 42. [As amended by Section 114 of the Revenue Act of 1941, c. 412, 55 Stat. 687]. PERIOD IN WHICH ITEMS OF GROSS INCOME INCLUDED.—

(a) *General Rule.*—The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period. In the case of the death of a tax-

payer there shall be included in computing net income for the taxable period in which falls the date of his death, amounts accrued up to the date of his death if not otherwise properly includible in respect of such period or a prior period.

(26 U. S. C. 1940 ed., Sec. 42.)

**SEC. 44. INSTALLMENT BASIS.**

(a) *Dealers in Personal Property.*—Under regulations prescribed by the Commissioner with the approval of the Secretary, a person who regularly sells or otherwise disposes of personal property on the installment plan may return as income therefrom in any taxable year that proportion of the installment payments actually received in that year which the gross profit realized or to be realized when payment is completed, bears to the total contract price.

(b) *Sales of Realty and Casual Sales of Personality [sic].*—In the case (1) of a casual sale or other casual disposition of personal property (other than property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year), for a price exceeding \$1,000, or (2) of a sale or other disposition of real property, if in either case the initial payments do not exceed 30 per centum of the selling price (or, in case the sale or other disposition was in a taxable year beginning prior to January 1, 1934, the percentage of the selling price prescribed in the law applicable to such year), the income may, under regulations prescribed by the Commissioner with the approval of the Secretary, be returned on the basis and in the manner above prescribed in this section. As used in this section the term "initial payments"

means the payments received in cash or property other than evidences of indebtedness of the purchaser during the taxable period in which the sale or other disposition is made.

\* \* \* \*

(26 U. S. C. 1940 ed., Sec. 44.)

**SEC. 111. DETERMINATION OF AMOUNT OF, AND RECOGNITION OF, GAIN OR LOSS.**

(a) *Computation of Gain or Loss.*—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 113 (b) for determining gain; and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

(b) *Amount realized.*—The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received.

(c) *Recognition of Gain or Loss.*—In the case of a sale or exchange, the extent to which the gain or loss determined under this section shall be recognized for the purposes of this chapter, shall be determined under the provisions of section 112.

(d) *Installment Sales.*—Nothing in this section shall be construed to prevent (in the case of property sold under contract providing for payment in installments) the taxation of that portion of any installment payment representing gain or profit in the year in which such payment is received.

(26 U. S. C. 1940 ed., Sec. 111.)

**SEC. 112. RECOGNITION OF GAIN OR LOSS.**

(a) *General Rule.*—Upon the sale or

exchange of property the entire amount of the gain or loss, determined under section 111, shall be recognized, except as hereinafter provided in this section.

(26 U. S. C. 1940 ed., Sec. 112.)

SEC. 115. DISTRIBUTION BY CORPORATIONS.

(1) [as added by Section 501 of the Second Revenue Act of 1940, c. 757, 54 Stat. 974, 1004] *Effect on Earnings and Profits of Gain or Loss and of Receipt of Tax-Free Distributions.*—The gain or loss realized from the sale or other disposition (after February 28, 1913) of property by a corporation—

(1) for the purpose of the computation of earnings and profits of the corporation, shall be determined, except as provided in paragraph (2), by using as the adjusted basis the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain, except that no regard shall be had to the value of the property as of March 1, 1913; but

(2) for the purpose of the computation of earnings and profits of the corporation for any period beginning after February 28, 1913, shall be determined by using as the adjusted basis the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain.

Gain or loss so realized shall increase or decrease the earnings and profits to, but not beyond, the extent to which such a realized gain or loss was recognized in computing net income under the law appli-

cable to the year in which such sale or disposition was made. \* \* \*

(26 U. S. C. 1940 ed., Sec. 115.)

## CHAPTER 2—ADDITIONAL INCOME TAXES

### SUBCHAPTER A—PERSONAL HOLDING COMPANIES.

SUBCHAPTER B [as amended by Section 506 of the Second Revenue Act of 1940, c. 757, 54 Stat. 974]—DECLARED VALUE EXCESS-PROFITS TAX.

### SUBCHAPTER C—EXCESS PROFITS ON NAVY CONTRACTS.

### SUBCHAPTER D—UNJUST ENRICHMENT.

SUBCHAPTER E—EXCESS PROFITS TAX [as added by Section 201 of the Second Revenue Act of 1940, supra, which provided that the new subchapter may be cited as the "Excess Profits Tax Act of 1940"].

SEC. 712 [as amended by Sec. 13 of the Act of March 7, 1941, c. 10, 55 Stat. 17].  
EXCESS PROFITS CREDIT-ALLOWANCE.

(a) *Domestic Corporations.*—In the case of a domestic corporation which was in existence before January 1, 1940, the excess profits credit for any taxable year shall be an amount computed under section 713 or section 714, whichever amount results in the lesser tax under this subchapter for the taxable year for which the tax under this subchapter is being computed. In the case of all other domestic corporations the excess



profits credit for any taxable year shall be an amount computed under section 714.

\* \* \*

\* \* \* \* \*

(26 U. S. C. 1940 ed., Supp. V, Sec. 712.)

SEC. 714 [as amended by Sec. 217 of the Revenue Act of 1942, c. 619, 56 Stat. 798].

EXCESS PROFITS CREDIT—BASED ON INVESTED CAPITAL.

The excess profits credit, for any taxable year, computed under this section, shall be the amount shown in the following table:

If the invested capital for the taxable year, determined under section 715, is:

The credit shall be:

Not over \$5,000,000--- 8% of the invested capital.

\* \* \* \* \*

(26 U. S. C. 1940 ed., Supp. V, Sec. 714.)

SEC. 715. DEFINITION OF INVESTED CAPITAL.

For the purposes of this subchapter the invested capital for any taxable year shall be the average invested capital for such year, determined under section 716, reduced by an amount computed under section 720 (relating to inadmissible assets). If the Commissioner finds that in any case the determination of invested capital, on a basis other than a daily basis, will produce an invested capital differing by not more than \$1,000 from an invested capital determined on a daily basis, he may, under regulations prescribed by him with the approval of the Secretary, provide for such determination on such other basis. (For computation of invested capital in case of foreign corporations and corporations entitled to the benefits of section 251, see section 724.) (26 U. S. C. 1940 ed., Sec. 715.)

### SEC. 716. AVERAGE INVESTED CAPITAL.

The average invested capital for any taxable year shall be the aggregate of the daily invested capital for each day of such taxable year, divided by the number of days in such taxable year. (26 U. S. C. 1940 ed., Sec. 716.)

### SEC. 717. DAILY INVESTED CAPITAL.

The daily invested capital for any day of the taxable year shall be the sum of the equity invested capital for such day plus the borrowed invested capital for such day determined under section 719. (26 U. S. C. 1940 ed., Sec. 717.)

### SEC. 718. EQUITY INVESTED CAPITAL.

(a) *Definition.*—The equity invested capital for any day of any taxable year shall be determined as of the beginning of such day and shall be the sum of the following amounts, reduced as provided in subsection (b)—

\* \* \* \*

(4) *Earnings and Profits at Beginning of Year.*—The accumulated earnings and profits as of the beginning of such taxable year;

\* \* \* \*

(26 U. S. C. 1940 ed., Sec. 718.)

### SEC. 728. MEANING OF TERMS USED.

The terms used in this subchapter shall have the same meaning as when used in Chapter 1. (26 U. S. C. 1940 ed., Sec. 728.)

Treasury Regulations 111, promulgated under the Internal Revenue Code:

SEC. 29.115-3. *Earnings or Profits.*—In determining the amount of earnings or profits (whether of the taxable year, or accumulated since February 28, 1913, or ac-

cumulated prior to March 1, 1913) due consideration must be given to the facts, and, while mere bookkeeping entries increasing or decreasing surplus will not be conclusive, the amount of the earnings or profits in any case will be dependent upon the method of accounting properly employed in computing net income. For instance, a corporation keeping its books and filing its income tax returns under sections 41, 42, and 43 on the cash receipts and disbursements basis may not use the accrual basis in determining earnings and profits; a corporation computing income on the installment basis as provided in section 44 shall, with respect to the installment transactions, compute earnings and profits on such basis; and an insurance company subject to taxation under section 204 shall exclude from earnings and profits that portion of any premium which is unearned under the provisions of section 204 (b) (5) and which is segregated accordingly in the unearned premium reserve.

\* \* \* Gains and losses within the purview of section 112 or corresponding provisions of prior Revenue Acts are brought into the earnings and profits at the time and to the extent such gains and losses are recognized under that section (see section 29.115-12). \* \* \*

\* \* \* \* \*

SEC. 29.115-12. *Effect on Earnings and Profits of Gain or Loss Realized After February 28, 1913.*—In order to determine the effect on earnings and profits of gain or loss realized from the sale or other disposition (after February 28, 1913) of property by a corporation, section 115 (1) prescribes certain rules for (1) the computation of the total earnings and profits of the corpo-

ration, of most frequent application in determining invested capital; and (2) the computation of earnings and profits of the corporation for any period beginning after February 28, 1913, of most frequent application in determining the source of dividend distributions. Such rules are applicable whenever under any provision of chapter 1 or 2 it is necessary to compute either the total earnings and profits of the corporation or the earnings and profits for any period beginning after February 28, 1913. \* \* \*

The gain or loss so realized increases or decreases the earnings and profits to, but not beyond, the extent to which such gain or loss was *recognized* in computing net income under the law applicable to the year in which such sale or disposition was made. As used in this subsection the term "recognized" has reference to that kind of realized gain or loss which is recognized for income tax purposes by the statute applicable to the year in which the gain or loss was realized, for example, see section 112. A loss (other than a wash sale loss with respect to which a deduction is disallowed under the provisions of section 118 or corresponding provisions of prior revenue laws) may be recognized though not allowed as a deduction (by reason, for example, of the operation of sections 24 (b) and 117 and corresponding provisions of prior revenue laws) but the mere fact that it is not allowed does not prevent decrease in earnings and profits by the amount of such disallowed loss. Wash sale losses, however, disallowed under section 118 and corresponding provisions of prior revenue laws, are deemed nonrecognized losses and do not

reduce earnings or profits. The "recognized" gain or loss for the purpose of computing earnings and profits is determined by applying the recognition provisions to the realized gain or loss computed under the provisions of section 115 (1) as distinguished from the realized gain or loss used in computing net income. The application of this paragraph may be illustrated by the following examples: \* \* \*

\* \* \* \* \*

Treasury Regulations 112, promulgated under the Internal Revenue Code:

**SEC. 35.718-2. *Determination of Daily Equity Invested Capital—Accumulated Earnings and Profits.***—(a) *In general*—The term "accumulated earnings and profits" is not defined in the Internal Revenue Code. See, however, section 115 and the regulations prescribed thereunder as to the effect of certain transactions on earnings and profits, and section 35.718-5 as to the effect of the declaration and distribution of dividends. In general, the concept of "accumulated earnings and profits" for the purpose of the excess profits tax is the same as for the purpose of the income tax.<sup>1</sup>

**SEC. 35.718-6. *Determination of Daily Equity Invested Capital—Reduction by Earnings and Profits of Another Corporation.***—Section 718 (b) (3) provides for the elimination of the duplication which occurs in the computation of the equity invested

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<sup>1</sup> Substantially the same provision appeared in Section 30.718-2 of Treasury Regulations 109, promulgated in 1941 under the Internal Revenue Code as amended by the Second Revenue Act of 1940.



capital of the taxpayer following a transaction of the character referred to therein, as a result of which the earnings and profits of another corporation became the earnings and profits of the taxpayer. The earnings and profits of such other corporation having been included at the time of the transaction in the earnings and profits of the taxpayer, they remain continuously thereafter a part of such earnings and profits account for the purpose of computing for any day after such transaction the earnings and profits, the accumulated earnings and profits at the beginning of the taxable year, and the earnings and profits of the taxable year. In addition, however, the amount of such included earnings and profits is also brought into computation of equity invested capital of the taxpayer under provisions of section 718 other than section 718 (a) (4) relating to accumulated earnings and profits as of the beginning of the taxable year. \* \* \*

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